Proposed statement of position : Disclosures of certain matters in the financial statements of insurance enterprises ;Disclosures of certain matters in the financial statements of insurance enterprises; Exposure draft (American Institute of Certified Public Accountants), 1994, Apr. 20

American Institute of Certified Public Accountants. Task Force on Insurance Companies' Disclosures

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

DISCLOSURES OF CERTAIN MATTERS IN THE FINANCIAL STATEMENTS OF INSURANCE ENTERPRISES

APRIL 20, 1994

Prepared by the Task Force on Insurance Companies' Disclosures
Accounting Standards Division
American Institute of Certified Public Accountants

Comments should be received by July 20, 1994, and addressed to
Dionne McNamee, Senior Technical Manager, Accounting Standards Division, File 3162.ID
AICPA, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1081

SUMMARY

This proposed statement of position (SOP) requires insurance enterprises, where applicable, to make the following disclosures in their financial statements prepared in conformity with generally accepted accounting principles (GAAP):

- Information about their regulatory risk-based capital (RBC).
- The accounting methods used in their statutory financial statements that are permitted by state insurance departments that are not prescribed statutory accounting practices.
- Information about their liabilities for unpaid property and casualty insurance claims and claim adjustment expenses.

The SOP would be effective for financial statements issued for fiscal years ending after December 15, 1994.

The exposure draft has been sent to—

- State society executive directors, presidents, and accounting and auditing committee chairs.
- Organizations concerned with financial reporting of insurance enterprises.
- Persons who have requested copies.

AICPA

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April 20, 1994

Accompanying this letter is an exposure draft of a proposed statement of position (SOP), *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises.* This proposed SOP has been developed by the AICPA Task Force on Insurance Companies' Disclosures (Task Force) and approved by the AICPA's Insurance Companies Committee and Accounting Standards Executive Committee (AcSEC).

This proposed SOP requires disclosure of risk-based capital amounts by all insurance enterprises. In an exposure draft of the Audit and Accounting Guide *Banks and Savings Institutions*, which will be issued after this exposure draft, AcSEC intends to require similar disclosures for those entities.

The National Association of Insurance Commissioner's (NAIC's) Model Act on risk-based capital prohibits disclosure of risk-based capital ratios in a variety of documents and situations. The Model Act also prohibits disclosure of risk-based capital reports and plans. The Task Force believes that those prohibitions do not apply to disclosures in financial statements, and has requested that the NAIC comment on this.

AcSEC invites comments both on the proposed SOP as a whole and on all matters in it, particularly on the following issues:

- **Property and casualty insurance reserves.** This SOP requires disclosure of management's policies and methods for difficult-to-estimate liabilities, such as claims for toxic-waste cleanup and asbestos-related illnesses. Further, the illustrative disclosure contains language about the uncertainties related to the extent of remediation of such claims. Respondents are asked:

  Based on the current estimation techniques available, does the illustrative disclosure appropriately adopt the requirements in the SOP?

- **Effective date.** The proposed SOP would be effective for 1994 financial statements.

  Assuming a final SOP is issued in late 1994, are there any reasons that the recommended disclosures could not be made in 1994 financial statements?

Comments should be sent to Dionne D. McNamee, Senior Technical Manager, Accounting Standards Division, File 3162.ID, AICPA, 1455 Pennsylvania Avenue, NW, Washington, DC 20004-1081, in time to be received by July 20, 1994.

Written comments on the exposure draft will be available for public inspection at the AICPA library after August 1, 1994, for one year.

Yours truly,

Norman N Strauss

Norman N. Strauss
Chair
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PROPOSED STATEMENT OF POSITION

DISCLOSURES OF CERTAIN MATTERS IN THE FINANCIAL STATEMENTS OF INSURANCE ENTERPRISES

INTRODUCTION

1. The phrase *generally accepted accounting principles* includes the sources of established accounting principles identified in AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report.* Most of the accounting principles related to disclosures for insurance enterprises were promulgated over twenty years ago when the insurance regulatory and business environments were less complex and volatile. Accordingly, the AICPA Accounting Standards Executive Committee (AcSEC) added a project to its agenda to consider whether new disclosures should be required so insurance enterprise financial statements better meet the objectives of financial reporting. This statement of position (SOP) is a result of that project.

SCOPE

2. This SOP applies to life and health insurance enterprises,[1] property and casualty insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies.

CONCLUSIONS

3. The conclusions in this section should be read in conjunction with appendix A, "Illustrative Disclosures," and appendix B, "Discussion of Conclusions," of this SOP. Though the conclusions in this SOP apply to annual financial statements prepared in conformity with generally accepted accounting principles (GAAP), AICPA Auditing Interpretation No. 12, *Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623), requires auditors to apply the same disclosure criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP.

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[1] Financial Accounting Standards Board (FASB) Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises,* clarifies that FASB Statements and Interpretations and Accounting Principles Board Opinions apply to mutual life insurance enterprises, except when specifically exempted, that prepare financial statements in conformity with generally accepted accounting principles (GAAP). Furthermore, the FASB Exposure Draft *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participation Contracts*, would extend to mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies the requirements of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.

Risk-Based Capital

4. Insurance enterprises that are required to calculate risk-based capital[2] should disclose in the notes to their financial statements the ratio of **total adjusted capital** to **authorized control level risk-based capital**[3] and the amount of total adjusted capital for each fiscal year for which a statement of financial position is presented. A description of the risk-based capital formulas and amounts that trigger a **regulatory event** also should be disclosed.

5. Further, an insurance enterprise whose level of risk-based capital has triggered a regulatory event—that is, the enterprise has failed to meet minimum risk-based capital requirements—should disclose the following:

a. Significant pertinent conditions and events giving rise to the failure to meet the minimum risk-based capital requirements

b. The possible effects of such conditions and events on the enterprise's operations

c. Reasonably possible regulatory sanctions, including discontinuance of operations

d. Management's evaluation of the significance of those conditions and events and any mitigating factors

e. A description of the insurance enterprise's comprehensive financial plan and relevant financial information

f. A statement as to whether the comprehensive financial plan has been accepted by regulatory authorities

The disclosure requirements in this paragraph apply only to the most recent fiscal year presented.

Permitted Statutory Accounting Practices

6. Insurance enterprises currently prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile. The NAIC currently has a project under way to codify statutory accounting practices through a complete revision of its *Accounting Practices and Procedures Manuals*, which, when complete, are expected to constitute the only source of statutory accounting practices. The codification project may result in changes to the accounting practices that insurance enterprises use to prepare their statutory financial statements and in changes to what is considered a prescribed versus a permitted statutory accounting practice.

7. Prescribed statutory accounting practices currently include state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state; *NAIC Annual Statement Instructions*; the NAIC *Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC *Examiners' Handbook*.

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[2] Final regulatory risk-based capital formulas and instructions for life insurance enterprises and property and casualty insurance enterprises have been issued by the National Association of Insurance Commissioners (NAIC), which has proposed a model law that the states are expected to adopt. Disclosure of the total adjusted capital and the authorized control level capital is required in life insurance enterprises' statutory filings for the year ended December 31, 1993, and in property and casualty insurance enterprises' statutory filings for the year ended December 31, 1994.

[3] Terms defined in the glossary (appendix C) are in **boldface** the first time they appear in this SOP.

8. Permitted statutory accounting practices include practices not prescribed in paragraph 7 but allowed by the domiciliary state insurance department. Insurance enterprises may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of their statutory financial statements (a) when the enterprise wishes to depart from the prescribed statutory accounting practices or (b) when prescribed statutory accounting practices do not address the accounting for the transaction(s). Accordingly, permitted statutory accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

9. Insurance enterprises that use permitted statutory accounting practices in their statutory financial statements should disclose in their financial statements prepared in conformity with GAAP the following information about such permitted statutory accounting practices:

a. A description of each type of transaction and the permitted statutory accounting practice used in the statutory financial statements

b. A statement that the permitted statutory accounting practice differs from prescribed statutory accounting practices or that prescribed statutory accounting practices do not address the accounting for the transaction

c. A statement that permission to use the particular accounting practice has been granted by the domiciliary state insurance department[4]

d. A statement that permitted statutory accounting practices differ from state to state, may differ from company to company within a state, and may change in the future

e. The monetary effect on statutory surplus of the permitted statutory accounting practices

f. The effect on risk-based capital of the permitted statutory accounting practices

The disclosure requirements in this paragraph should be made for any permitted statutory transactions that affect statutory surplus for the most recent fiscal year presented, regardless of when the permitted statutory accounting practice was initiated.

10. Furthermore, regardless of whether they use permitted statutory accounting practices, insurance enterprises should include in their financial statements prepared in conformity with GAAP a reference to the NAIC's project to codify statutory accounting practices and state that the codification (a) is expected to constitute the only source of prescribed statutory accounting practices, (b) likely will change the definitions of what constitutes prescribed versus permitted statutory practices, and (c) may result in changes to the accounting policies that insurance enterprises use to prepare their statutory financial statements.

Property and Casualty Insurance Reserves

11. Insurance enterprises with property and casualty insurance reserves should disclose in their financial statements prepared in conformity with GAAP the following information about their **liability for unpaid claims and claim adjustment expenses:**

[4] SOP 94-1, *Inquiries of State Insurance Regulators,* provides guidance to auditors on obtaining sufficient competent evidential matter to corroborate management's assertion that permitted practices are allowed by the domiciliary state insurance department.

a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of each fiscal year presented, which may be presented net of reinsurance with separate disclosure of the related amount of reinsurance recoverable

b. Incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and for increases or decreases in the provision for insured events of prior fiscal years (Also, the enterprise should discuss the reasons for the change in the provision for incurred claims and claim adjustment expenses attributable to insured events of prior fiscal years and should indicate whether additional premiums or returned premiums have been accrued as a result of the prior-year effects.)

c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years

d. Management's policies and methodologies used for establishing the liability for unpaid claims and claim adjustment expenses on difficult-to-estimate liabilities, such as claims for toxic waste cleanup, asbestos-related illnesses, and residual market business (such as workers' compensation)

12. Further, if in estimating its liability for unpaid claims and claim adjustment expense an insurance enterprise adjusts its past loss experience for significant favorable or unfavorable claims experience the enterprise believes to be **nonrecurring and abnormal,** the enterprise should disclose—

a. The fact that past claims experience was adjusted for significant claims experience the enterprise believes to be nonrecurring and abnormal.

b. The nature of the claims experience that is considered nonrecurring and abnormal.

13. The disclosure requirements in paragraphs 11 and 12 apply to all fiscal years for which an income statement is presented.

EFFECTIVE DATE AND TRANSITION

14. This SOP is effective for annual financial statements for fiscal years ending after December 15, 1994. Disclosures in the year of transition of information required by paragraph 4 need not be included for financial statements that are being provided for comparative purposes for fiscal years ending before the effective date of this SOP. Disclosures in the year of transition of information required by paragraphs 11 and 12 should be included for each fiscal year for which an income statement is presented for comparative purposes.

APPENDIX A

ILLUSTRATIVE DISCLOSURES

A.1. The illustrations included in this appendix are guides to implementation of the disclosures required by this proposed SOP. Insurance enterprises are not required to display the information contained herein in the specific manner or in the degree of detail illustrated. Alternative ways of disclosing the information are permissible as long as they satisfy the disclosure requirements of this SOP.

Risk-Based Capital

A.2. The following is an illustration of risk-based capital disclosures that an insurance enterprise, with total adjusted capital that meets the minimum risk-based capital requirements, would disclose to meet the requirements of paragraph 4 of this SOP.

Note X. Regulatory Risk-Based Capital. The state of domicile imposes minimum risk-based capital requirements on insurance enterprises that were developed by the National Association of Insurance Commissioners (NAIC). The formulas for determining the amount of risk-based capital specify various weighting factors that are applied to financial balances or various levels of activity based on the perceived degree of risk. Regulatory compliance is determined by a ratio of the enterprise's regulatory total adjusted capital, as defined by the NAIC, to its authorized control level risk-based capital, as defined by the NAIC. Enterprises below specific trigger points or ratios are classified within certain levels, each of which requires specified corrective action. The levels and ratios are as follows.

Regulatory Event	*Ratio of Total Adjusted Capital to Authorized Control Level Risk-Based Capital (Less Than or Equal to)*
Company action level	2 (or 2.5 with negative trends)
Regulatory action level	1.5
Authorized control level	1
Mandatory control level	.7

ABC has regulatory total adjusted capital of $XX million and $XX million at December 31, 19X4, and 19X3, respectively, and a ratio of regulatory total adjusted capital to authorized control level risk-based capital of 3.1 and 3.0 at December 31, 19X4, and 19X3, respectively. Accordingly, ABC meets the minimum risk-based capital requirements.

A.3. The following is an illustration of risk-based capital disclosures that an insurance enterprise, with total adjusted capital that has triggered a regulatory event, would disclose to meet the requirements of paragraphs 4 and 5 of this SOP.

Note Y. Regulatory Risk-Based Capital. The state of domicile imposes minimum risk-based capital requirements on insurance enterprises that were developed by the National Association of Insurance Commissioners (NAIC). The formulas for determining the amount of risk-based capital specify various weighting factors that are applied to financial balances or various levels of activity based on the perceived degree of risk. Regulatory compliance is determined by a ratio of the enterprise's regulatory total adjusted capital, as defined by the NAIC, to its authorized control level risk-based capital, as defined by the NAIC. Enterprises below specific trigger points or ratios are classified within certain levels, each of which requires specified corrective action. The levels and ratios are as follows.

Regulatory Event	*Ratio of Total Adjusted Capital to Authorized Control Level Risk-Based Capital (Less Than or Equal to)*
Company action level	2 (or 2.5 with negative trends)
Regulatory action level	1.5
Authorized control level	1
Mandatory control level	.7

DEF has regulatory total adjusted capital of $XX million and $XX million at December 31, 19X4, and 19X3, respectively, and a ratio of regulatory total adjusted capital to authorized control level risk-based capital of 1.9 and 2.1 at December 31, 19X4, and 19X3, respectively. Accordingly, DEF failed to meet the minimum regulatory risk-based capital requirements and has triggered a company action level event.

DEF has suffered recurring losses from operations. [*This disclosure should include any other information regarding pertinent conditions and events giving rise to the failure to meet the minimum risk-based capital requirements*.]

[*This disclosure also should include any pertinent information about management's evaluation of the significance of the losses from operations and events and any mitigating factors.*]

Enterprises that have triggered a company action level event are required to submit a detailed comprehensive financial plan to the domiciliary state insurance department. In the regulatory action level, in addition to submitting the comprehensive financial plan, an enterprise may be subjected to a detailed regulatory investigation. The domiciliary state insurance department is permitted, but not required, to place the insurance enterprise under regulatory control when it falls to the authorized control level; regulatory control is required in the mandatory control level.

On December 10, 19X4, DEF filed a detailed comprehensive financial plan with the XYZ state insurance department, outlining its plans for attaining the required level of risk-based capital by December 31, 19X6. The plan was developed after review of the company's operations, its present market position, and its current resources. The principal elements of the plan are (a) a return to operating profitability and (b) sale of certain high-risk debt securities with a market value of $XX million at December 31, 19X4.

The company plans to achieve a return to operating profitability through [*describe course of action*].

XYZ state insurance department has not acted on DEF's comprehensive financial plan. If the insurance department does not accept DEF's plan, DEF will be required to modify and submit a new comprehensive plan acceptable to the insurance department or DEF may be subjected to detailed regulatory investigation.

Permitted Statutory Accounting Practices

A.4. The following is an illustration of disclosures that an insurance enterprise would disclose to meet the requirements of paragraphs 9 and 10 of this SOP. In certain situations—particularly if in the absence of the permitted transaction the insurance enterprise fails to meet minimum risk-based capital requirements—insurance enterprises may deem it appropriate to include this disclosure with the risk-based capital disclosures.

Note X. Permitted Statutory Accounting Practices. The Company, which is domiciled in ABC state, prepares its statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the ABC state insurance department. Prescribed statutory accounting practices include state laws, regulations, and general administrative rules, as well as a variety of publications of the National Association of Insurance Commissioners (NAIC). Permitted statutory accounting practices encompass all accounting practices that are not prescribed; such practices differ from state to state, may differ from company to company within a state, and may change in the future. Furthermore, the NAIC has a project to codify statutory accounting practices, the result of which is expected to constitute the only source of "prescribed" statutory accounting practices. Accordingly, that project, which is expected to be completed in 1995, will likely change the definitions of what comprises prescribed versus permitted statutory accounting practices, and may result in changes to the accounting policies that insurance enterprises use to prepare their statutory financial statements.

The Company received written approval from the ABC state insurance department to discount loss reserves at a rate of X percent for statutory accounting purposes, which differs from prescribed statutory accounting practices. Statutory accounting practices prescribed by ABC state require that loss reserves be discounted at Y percent. As of December 31, 19X3, that permitted transaction increased statutory surplus by $XX million over what it would have been had prescribed accounting practice been followed. If the Company had not used that practice, its ratio of regulatory total adjusted capital to authorized control level risk-based capital would have been 2.5. (Risk-based capital is discussed further in note X.)

Property and Casualty Insurance Reserves

A.5. The following is an illustration of information an insurance enterprise may disclose to meet the requirements of paragraph 11 of this SOP for property and casualty insurance reserves. (The company should make additional disclosures under paragraph 12, if applicable.)

Note X. Unpaid Claims and Claim Adjustment Expenses. Activity in the unpaid claims and claim adjustment expense is summarized as follows.

	19X5	19X4
Balance as of January 1, net of reinsurance recoverables of $X and $X	$5,796	$5,700
Incurred related to:		
Current year	2,700	2,600
Prior years	(171)	96
Total incurred	2,529	2,696
Paid related to:		
Current year	781	800
Prior years	2,000	1,800
Total paid	2,781	2,600
Balance as of December 31, net of reinsurance recoverables of $X and $X	$5,544	$5,796

As a result of changes in estimates of insured events in prior years, the provision of claims and claim adjustment expenses, which is net of reinsurance recoveries of $X and $X in 19X5 and 19X4, respectively, decreased by $171 million in 19X5 due to lower than anticipated losses on Hurricane Andrew and increased by $96 million in 19X4 due to higher than anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

Reserves for asbestos-related illnesses and toxic waste cleanup claims cannot be estimated with traditional loss reserving techniques. Case reserves (and costs of related litigation) have been established when sufficient information has been developed to indicate the involvement of a specific insurance policy. In addition, incurred-but-not-reported reserves have been established to cover additional exposures on both known and unasserted claims. These reserves are reviewed and updated continually. In establishing liabilities for claims for asbestos-related illnesses and for toxic waste cleanup claims, management considers facts currently known and the current state of the law and coverage litigation. However, given the expansion of coverage and liability by the courts and the legislatures in the past and the possibilities of similar interpretations in the future, there is significant uncertainty regarding the extent of remediation. Accordingly, an indeterminable amount of additional liability could develop.

DISCUSSION OF CONCLUSIONS

B.1. This section discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

B.2. The primary sources of GAAP for insurance activities of insurance enterprises are—

- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.*
- FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments.*
- FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.*
- FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises.*[5]

B.3. FASB Statement No. 60, which contains most of the disclosure requirements for insurance companies, was developed more than twenty years ago. Also, the business and regulatory environment of insurance enterprises has become more complex and volatile. Accordingly, AcSEC decided to reconsider the disclosure requirements of all insurance enterprises.

B.4. FASB Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises,* says financial reporting should "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). Further, the Concepts Statement says that to support that decision-making process, financial reports should help such users "assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprises" (paragraph 37) by providing "information about the economic resources of an enterprise, the claims to those resources ... and the effects of transactions, events, and circumstances that change resources and claims to those resources" (paragraph 40). After considering a wide variety of potential disclosures, AcSEC concluded that additional disclosures in the financial statements of insurance enterprises, about regulatory risk-based capital, the liability for unpaid claims and certain accounting methods permitted by state insurance departments would result in financial statements of insurance enterprises better meeting those objectives.

Risk-Based Capital

B.5. Insurance enterprises operate in a highly regulated environment directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the insurance system. Historically, regulation of insurance enterprises has monitored solvency by focusing on their capital. One of the primary tools used by state insurance departments for ensuring that their objectives are being met is risk-based capital.

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[5] Furthermore, the FASB has issued an exposure draft of a FASB Statement, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participation Contracts.*

B.6. The National Association of Insurance Commissioners (NAIC) has developed a risk-based capital program that is used by state insurance departments to make sure they take appropriate and timely regulatory actions relating to insurers that show signs of weak or deteriorating conditions.

B.7. Risk-based capital is a series of dynamic surplus formulas similar to target surplus formulas used by commercial rating agencies. The formulas specify various weighting factors that are applied to financial balances or to various levels of activity based on the perceived degree of risk and are set forth in the NAIC's risk-based capital instructions. Those formulas focus on four general types of risk: (a) asset risk, (b) credit risk and interest rate risk, (c) underwriting risk, and (d) all other business risks (management, regulatory action, and contingencies). The amount determined under such formulas is called the authorized control level risk-based capital (ACLC).

B.8. The NAIC's risk-based capital instructions[6] establish a framework for linking various levels of regulatory corrective action to the relationship of an insurance enterprise's total adjusted capital (TAC) to the calculated ACLC risk-based capital. The current levels of regulatory actions, the trigger points, and the corrective actions are summarized as follows.

Level	*Trigger*	*Corrective Action*
Company action level	TAC is less than or equal to 2 × ACLC or TAC is less than or equal to 2.5 × ACLC with negative trend	Insurance enterprise must submit a comprehensive plan to the state insurance commissioner.
Regulatory action level	TAC is less than or equal to 1.5 × ACLC or an unsatisfactory comprehensive plan	In addition to the action above, the state insurance commissioner is required to perform examination or analysis deemed necessary and issue the corrective order, specifying corrective actions required.
Authorized control level	TAC is less than or equal to 1.0 × ACLC	In addition to the actions described above, the state insurance commissioner is permitted, but not required, to place the insurer under regulatory control.
Mandatory control level	TAC is less than or equal to .7 × ACLC	The state insurance commissioner is required to place the insurance enterprise under regulatory control.

[6] The risk-based capital instructions may be amended by the NAIC from time to time in accordance with procedures adopted by the NAIC.

B.9. Under the risk-based capital requirements, the comprehensive financial plan should –

- Identify the conditions in the insurer that contribute to the failure to meet the capital requirements.
- Contain proposals of corrective actions the insurer intends to take that would be expected to result in compliance with the capital requirements.
- Provide projections of the insurer's financial results in the current year and at least the four succeeding years, both in the absence of proposed corrective actions and giving effect to the proposed corrective actions, including projections of statutory operating income, net income, capital and/or surplus.
- Identify the key assumptions affecting the insurer's projections and the sensitivity of the projections to the assumptions.
- Identify the quality of, and problems associated with, the insurer's business, including but not limited to its assets, anticipated business growth and associated surplus strain, extraordinary exposure to risk, mix of business, and use of reinsurance in each case, if any.

B.10. AcSEC believes that, because of the importance of risk-based capital in the regulatory oversight of insurance enterprises, its disclosure would provide relevant information to the users of the financial statements. AcSEC considered arguments that risk-based capital should be disclosed only by insurance enterprises whose total adjusted capital falls below the NAIC's minimums. AcSEC acknowledges that the risk-based capital may be more relevant to users of financial statements of those insurance enterprises than for insurance enterprises whose total adjusted capital far exceeds the minimums but concluded that risk-based capital is relevant information for all insurance enterprises. Furthermore, AcSEC notes that insurance enterprises are required to disclose their risk-based capital in statutory filings with state insurance departments. Finally, AcSEC notes that it has proposed requiring similar disclosures about regulatory capital in the exposure draft of the Audit and Accounting Guide *Banks and Savings Institutions*.

Permitted Statutory Accounting Practices

B.11. Permitted statutory accounting practices historically have not been disclosed in the notes to the financial statements. It has become increasingly common for insurance enterprises to have transactions that are not addressed by prescribed accounting practices or for which the prescribed accounting practices lack sufficient clarity. Furthermore, it has become increasingly common for insurance enterprises to request exceptions from certain prescribed accounting practices. Permitted statutory accounting practices may differ from state to state and from company to company within a state and may change in the future. Moreover, permitted statutory accounting practices are often used to enhance insurance enterprises' surplus positions. For example, some state insurance departments have permitted certain insurance enterprises to write up home office facilities to appraised values even though the states' prescribed statutory accounting practices require that such assets be carried at depreciated historical costs.

B.12. AcSEC believes requiring disclosure of permitted statutory accounting practices would enhance the relevance of the financial statements and fulfill the financial reporting objective of providing current and potential investors, creditors, and policyholders and other users of an insurance enterprise's financial statements with information that would be useful in making rational decisions. Not only would such disclosures identify situations in which permitted statutory accounting practices enhance an insurance enterprise's statutory capital and risk-based capital position but they also would improve the comparability of insurance companies' financial statements.

Property and Casualty Insurance Reserves

B.13. Property and casualty insurance enterprises estimate their liability for unpaid claims and claim adjustment expenses for reported and unreported claims incurred as of the end of the accounting period in accordance with FASB Statement No. 60. The liability is estimated based on past loss experience, adjusted for current trends and any other factors that would modify past experience, and may be calculated using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models.

B.14. FASB Statement of Concepts 1, paragraph 21, states:

> The information provided by financial reporting largely reflects the financial effects of transactions and events that have already happened. Management may communicate information about its plans or projections, but financial statements and most other financial reporting are historical....Estimates resting on expectations of the future are often needed in financial reporting, but their major use, especially of those formally incorporated in financial statements, is to measure financial effects of past transactions or events or the present status of an asset or liability....To provide information about the past as an aid in assessing the future is not to imply that the future can be predicted merely by extrapolating past trends or relationships. Users of the information need to assess the possible or probable impact of factors that may cause change and form their own expectations about the future and its relation to the past.

B.15. AcSEC believes that disclosures about an insurance enterprise's claims and claim adjustment expense reserve development would be useful in understanding the liability. Furthermore, AcSEC notes the disclosures would be the same as some of the loss reserve development disclosures the Securities and Exchange Commission requires of registrants that file with the commission under Securities Act Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property–Casualty Insurance Underwriters*.

B.16. Paragraph 60(a) of FASB Statement No. 60 requires all insurance enterprises to disclose the basis for estimating the liabilities for unpaid claims and claim adjustment expenses. Furthermore, FASB Statement No. 5, *Accounting for Contingencies*, requires disclosure of loss contingencies not accrued for which it is at least reasonably possible that a loss has been incurred. Because of the relatively high degree of coverage litigation and the lack of historical information regarding the amount and nature of both known and unasserted claims relating to emerging or difficult to estimate liabilities, such as those related to environmental related illness claims and toxic-waste cleanup claims, traditional loss reserving techniques are not considered effective in estimating such liabilities. Therefore, there is a high degree of judgment involved in estimating the amount of losses and practice is developing in the area. Accordingly, AcSEC believes financial statement users would benefit from the disclosures of management's policies and methods used for establishing these amounts.

APPENDIX C

GLOSSARY

Authorized control level risk-based capital. The capital standard prescribed by the National Association of Insurance Commissioners (NAIC) is used in the regulation of insurance enterprises' solvency by state insurance departments. It is the number determined under the NAIC's risk-based capital formulas, which are part of the NAIC's annual statement instructions. (Separate formulas exist for life and health insurance enterprises and property and casualty insurance enterprises.)

Liability for unpaid claims and claim adjustment expenses. The amount needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the statement of financial position date). The estimated liability includes the amount of money that will be required for future payments of (a) claims that have been reported to the insurer, (b) claims related to insured events that have occurred but that have not been reported to the insurer as of the date the liability is estimated, and (c) claim adjustment expenses. Claim adjustment expenses include costs incurred in the claim settlement process such as legal fees, outside adjuster fees, and costs to record, process and adjust claims.

Negative trend. A negative trend over a period of time, as defined in accordance with the trend test calculation included in the risk-based capital instructions in the *NAIC Annual Statement Instructions*.

Nonrecurring and abnormal. A transaction or event that is not likely to recur in the foreseeable future and deviates from the norm.

Regulatory event. Under the NAIC's proposed model act, when the ratio of total adjusted capital to authorized control level risk-based capital is less than or equal to 2 or less than or equal to 2.5 with negative trends, a regulatory event exists—that is, the insurance enterprise fails to meet the minimum risk-based capital requirements. There are four types of regulatory events, ranging from least to most serious: company action level event, regulatory action level event, authorized control level event, and mandatory control level event.

Total adjusted capital. The amount of statutory capital and surplus plus other items provided for in the NAIC's risk-based capital instructions (such as asset valuation reserves and any voluntary investment reserves, plus 50 percent of dividend liability, and certain other specified adjustments).